TR 96/14 - Income tax: traditional securities

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Taxation Ruling
Income tax: traditional securities

other Rulings on this topic

IT 2517; IT 2643; TR 92/1; TR 92/10; TR 92/20

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*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]*

What this Ruling is about

Class of person/arrangement

1. This Ruling considers a number of interpretive matters in relation to section 26BB and section 70B of the *Income Tax Assessment Act 1936* ('the Act'). These sections deal with traditional securities.

2. A traditional security is, broadly, a security that is not issued at a discount of more than 1.5%, does not bear deferred interest and is not capital indexed. A traditional security may be, for example, a bond, a debenture, a deposit with a financial institution or a secured or unsecured loan.

3. A gain made on the disposal or redemption of a traditional security is included in assessable income under section 26BB. Section 70B provides that a loss on disposal or redemption of a traditional security may be an allowable deduction.

3A. The *New Business Tax System (Taxation of Financial Arrangements) Act (No. 1) 2003*, amended sections 26BB and 70B of the *Income Tax Assessment Act 1936* by inserting subsections 26BB(4) and 26BB(5) and subsections 70B(2B) and 70B(2C). The effect of these amendments is that subsections 26BB(2) and 70B(2) do not apply to the disposal or redemption of a traditional security if the security:

i) was issued after 7:30pm by legal time in the Australian Capital Territory on 14 May 2002; and

ii) was issued on the basis that the security will or may be:

a. disposed of or redeemed because of conversion into ordinary shares of the issuer or a connected entity of the issuer;

b. redeemed for ordinary shares in a company other than the issuer or a connected entity of the issuer; or

c. disposed of to the issuer or a connected entity of the issuer in exchange for ordinary shares in a company other than the issuer or a connected entity of the issuer; and

iii) the disposal or redemption took place pursuant to a provision of the issue of the security that is listed at (ii) above.

Accordingly, this Ruling does not apply to disposals or redemptions of traditional securities that fall within the terms of these amendments.

Ruling

4. We have formed the following views about a number of interpretive issues in relation to the traditional securities provisions of the Act:

i) paragraph (a) of the definition of 'security' in subsection 159GP(1) of the Act includes securities which are generally recognised as debt instruments. Having regard to paragraphs (a), (b) and (c) of the definition, only those contracts that have debt like obligations will usually fall under paragraph (d) of the definition;

ii) in the usual case of a unit in a property or cash management public unit trust, the unit is not within paragraph (a) of the definition of security in subsection 159GP(1). There may be a contract between the manager and unit holder under which there is a liability to pay an amount. This contract will be a security by virtue of paragraph (d) of the definition if, on the facts, it is found to be debt like;

iii) a guarantor's right of indemnity against a principal debtor is either contractual in nature or may be a restitutionary remedy. An indemnity contract between a debtor and a guarantor is not within paragraphs (a), (b) or (c) of the definition of security in subsection 159GP(1). However, a guarantor's right of indemnity has been found to be a security within paragraph (d) of the definition. As the

restitutionary right that a guarantor may have against a debtor is not founded in contract, it is not within paragraph (d) of the definition. It cannot, therefore, be a traditional security;

iv) the forgiveness or waiver of a debt that is a traditional security does not constitute a disposal of the security for the purposes of the traditional securities provisions;

v) a traditional security issued by a company that has gone into liquidation is not disposed of when the liquidator has made a final payment to the holder of the security or where no payments are to be made by the liquidator;

vi) a security will not be taken to have been disposed of at the time of the death of the holder. However, sections 26BB and 70B fall for consideration when the executor of the deceased estate disposes of the security otherwise than by transferring the security to a beneficiary of the estate, or the security is redeemed;

vii) subsection 70B(3) enables the Commissioner to substitute an amount as consideration for the acquisition of a traditional security or as consideration in respect of the disposal of a traditional security where parties are not dealing at arm's length. If it is possible or practicable to determine the arm's length consideration, that amount will be substituted as the acquisition or disposal consideration. A discounted cash flow analysis may be used where there is no established market from which the arm's length value can be ascertained. This discounted cash flow analysis will not apply to deem a gain under section 26BB;

viii) Part IVA may be applied to certain disposal arrangements entered into between non-arm's length parties where the requirements of the Part are satisfied.

ix) the amount of any 'gain' on the disposal or redemption of a traditional security is the difference between the consideration for the acquisition of the security plus any relevant costs associated with the acquisition or disposal, and the consideration received on the disposal of the security;

x) for the purposes of section 21, the money value of shares received as consideration for the disposal of a traditional security is their market value at the time they were received;

xi) a gain or loss made by the issuer of a traditional security when redeeming the security is not assessable under section 26BB or deductible under section 70B;

xii) a 'deposit' within the meaning of paragraph (b) of the definition of security in subsection 159GP(1) includes a fixed or term deposit and a current or savings account with a financial institution. A traditional security that is a fixed or term deposit is acquired when the contract between the bank and the depositor is made. A traditional security, being the debt due to a current or savings account holder, is acquired when the account is opened; and

xiii) an inter-company loan account can have similar characteristics to a current account with a financial institution. In such cases, we believe that the traditional securities' provisions apply to inter-company loan accounts in the same way that they apply to current accounts.

5. Our policy in relation to penalties and interest on understatements of taxable income in tax returns for the 1991-92 income year where an amendment is made after 30th June 1992 is set out in Taxation Ruling TR 92/10. Broadly, the principles of the self assessment penalty legislation and changes to the section 170AA rate of interest are to apply.

6. The principles contained in Taxation Ruling IT 2517 will apply to income tax returns for income years prior to 1991-92. Voluntary disclosures made in relation to losses claimed on traditional securities could be expected to result in the application of a 'per annum' component only of penalty tax.

Date of effect

7. This Ruling applies to years commencing both before and after its date of issue.

8. It should be noted that the views expressed in this Ruling differ in some respects from those proposed in Draft Taxation Ruling TR 93/D43. In particular, the view of what constitutes a disposal for the purposes of sections 26BB and 70B is different. Nonetheless, in the circumstances, we do not believe that grounds exist which justify an exception (as detailed at paragraphs 15 to 20 of Taxation Ruling TR 92/20) to the past and future application of this Ruling.

9. Draft Taxation Rulings are issued for comment and are explicitly prefaced by a cautionary statement to the effect that they

may not be relied on and do not represent authoritative statements by the ATO.

10. In any event, to the extent that the changes between draft and final rulings are adverse to taxpayers, they will affect to a greater extent the taxation outcomes of events which occurred before 1 July 1992. As TR 93/D43 issued on 21 October 1993, its contents could not have influenced the actions of taxpayers before 1 July 1992 or the preparation of tax returns for the 1992 income year.

11. Further, subsection 70B(5) was inserted into the Act by *Taxation Laws Amendment Act (No 5) 1992* (Act No 224 of 1992) and explicitly prevents the waiver or release of a debt or right on or after 1 July 1992 from being a disposal for the purposes of section 70B. The relevant Bill was introduced into the House of Representatives on 12 October 1992, and the Explanatory Memorandum accompanying that Bill stated that:

> 'In particular, it cannot be implied from the enactment of the rule [i.e., subsection 70B(5)] that the waiver or release of a debt prior to 1 July 1992 constituted the disposal or redemption of a traditional security.'

12. This Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of TR 92/20).

Note: The Addendum to this Ruling that issued on 24 March 2004, applies from 7.30pm by legal time in the Australian Capital Territory on 14 May 2002.

Note 2: The Addendum to this Ruling that issued on 11 July 2007 applies on and from 11 July 2007.

Explanations

Background

13. Section 26BB and section 70B were introduced into the Act by the *Taxation Laws Amendment Act (No 3) 1989* and apply to traditional securities acquired after 10 May 1989. The former subsection 160ZB(6) was also enacted at that time. It provided that capital gains and capital losses were not to be taken to have accrued in relation to traditional securities 'disposed of ... within the meaning of section 26BB'. A failure to satisfy the strict test of disposal in the traditional security provisions, therefore, will not prohibit a loss under the capital gains provisions where the definition of disposal is broader. For example, paragraph 160M(3)(b) applies to deem a disposal where there has been a 'cancellation, release, discharge,

satisfaction, surrender, forfeiture, expiry or abandonment of the asset'. A properly documented forgiveness would usually come within that provision.

14. Section 70B has since been amended, with effect from 1 July 1992 inclusive, and subsection 160ZB(6) repealed with effect from the same date. The amendments to section 70B prevent deductions being allowable in some circumstances for a capital loss on the disposal or redemption of a traditional security that is attributable to the inability or unwillingness of the issuer to discharge its obligations to make payments under the security. Any loss incurred on the forgiveness of a loan is now explicitly precluded by these amendments from being a deductible loss.

15. Sections 26BB and 70B may be contrasted with the provisions of Division 16E of the Act which subject certain securities to an accruals taxation regime. A number of terms used in sections 26BB and 70B have the same defined meaning as terms used in Division 16E.

16. Division 16E was enacted in response to an increase in certain kinds of investments and other structured financial transactions which deferred the payment of income from the transaction to the investor. The kinds of instruments used or financial transactions entered into became known collectively as 'discounted and other deferred interest securities'. There were tax deferral advantages associated with investing in these securities instead of traditional interest-bearing securities. The provisions of Division 16E were designed to eliminate those advantages.

Securities

17. The traditional securities' provisions adopt (at subsection 26BB(1)) without any qualification the following definition of 'security' at subsection 159GP(1) in Division 16E:

> ' "**security**" means-
>
> (a) stock, a bond, debenture, certificate of entitlement, bill of exchange, promissory note or other security;
>
> (b) a deposit with a bank, building society or other financial institution;
>
> (c) a secured or unsecured loan; or
>
> (d) any other contract, whether or not in writing, under which a person is liable to pay an amount or amounts, whether or not the liability is secured.'

18. The Explanatory Memorandum accompanying the *Taxation Laws Amendment Act (No 2) 1986* which introduced Division 16E into the Act states (at 58):

> ' "security" has been defined very widely, and includes items that may not be usually regarded as securities, e.g., contracts, so as to encompass various arrangements that may give rise to a deferral in the payment of income.'

19. The Division applies to securities with certain characteristics. They are called 'qualifying securities'. A qualifying security is, broadly, a security issued after 16 December 1984 for a period that is reasonably likely to exceed 12 months, under terms whereby it is reasonably likely that the security will produce receipts (other than of periodic interest) which are in excess of the issue price of the security.

20. Subject to some specific exemptions, a security which is not a 'qualifying security' will generally be a traditional security.

21. The mischief which Division 16E is designed to overcome is the deferral of income. In contrast, sections 26BB and 70B are primarily concerned with the characterisation of certain receipts and losses as assessable income or allowable deductions.

22. It was intended that sections 26BB and 70B would apply upon the disposal or redemption of a security to gains and losses attributable to changes in the value of the security due to movements in interest rates or other market adjustments. In one sense the gain or loss due to those changes is the equivalent of a return on funds invested, the return being of a revenue nature. It has always been difficult to characterise gains and losses made in respect of the redemption of securities issued or redeemable at a discount or premium that otherwise paid periodic interest. Much depended on the circumstances of each case: see, for example, the speech of Lord Green MR in *Lomax (HM Inspector of Taxes) v. Peter Dixon & Co Ltd* [1943] 2 All ER 255; see also the decision in *FC of T v. Hurley Holdings (NSW) Pty Ltd* (1989) 20 ATR 1293; 89 ATC 5033 in relation to the characterisation of gains from securities. With traditional securities ordinarily paying commercial rates of interest, necessarily issued at or near par and redeemable at their face value, any profit or loss on disposal would, except in the most unusual circumstances, have a revenue rather than a capital character. Sections 26BB and 70B ensure that in most cases any profit or loss on the disposal of traditional securities that arises from arm's length dealings between the parties will be an assessable profit or deductible loss.

23. The following issues have been raised in relation to the traditional securities provisions and the operation of, in particular, section 70B of the Act.

The meaning of 'or other security' in paragraph (a) of the definition of a security

24. The Explanatory Memorandum which accompanied Division 16E doesn't comment on the use of the term 'or other security' but states (at 13):

> 'Paragraph (a) of the definition refers to items that are usually taken to be a security.'

25. The word 'security' may be used in a number of quite distinct ways. In *Singer v. Williams* [1920] All ER Rep Ext 819, Lord Cave said (at 822):

> 'The normal meaning of the word "securities" is not open to doubt. The word denotes a debt or claim the payment of which is in some way secured. The security would generally consist of a right to resort to some fund or property for payment...where the word is used in its normal sense, some form of secured liability is postulated.'

Paragraphs (c) and (d) of the definition in subsection 159GP(1) refer to loans and other contracts and indicate that they may or may not be secured. This is using the word 'secured' in the manner just described above: see also E I Sykes and S Walker, *The Law of Securities*, 4th edition, 1993, Law Book Company, at 3.

26. Edna Carew, *The Language of Money*, 1987, Allen and Unwin, states (at 217):

> 'In the context of financial markets, "securities" are written undertakings securing repayment of money.'

27. The context in which the word is used may require yet a wider purview. For example, the word security is capable of describing an interest such as ground-rent (*Re Tapp and London and India Docks Company's Contract* (1905) 74 LJ Ch 523) and has been said to be a synonym for the word investment: see *Re Rayner* [1904] 1 Ch 176 and *Re Gent and Eason's Contract* [1905] 1 Ch 386.

28. In *Re United Law Clerks Society* [1946] 2 All ER 674, Evershed J considered the meaning of the phrase 'any other security' in the context of the *Friendly Societies Act 1896* (UK). At 675, His Honour said:

> 'The sole point in the appeal is whether the word "security" occurring in the phrase "any other security" in s.44(1)*(e)* of the Act of 1896, is meant to include any form of investment of money or must be confined to the stricter or more narrow significance of debts or money claims the payment of which is "secured" or "guaranteed" by a charge on some property or by

> some document recording the obligation of some person or corporation to pay and so as not to include the holding of shares in limited companies which are of the nature of participations in an enterprise and do not involve the conception of a debtor-creditor relationship.
>
> There is no doubt that at the present day the words "security" and "securities" are not uncommonly used as synonymous with "investment" or "investments," and it is tempting in a case such as the present so to stretch the meaning of the words. Several cases were cited in argument to illustrate this popular usage of which *Re Rayner* is an example. It is necessary for me to refer in detail to the authorities since it was conceded by counsel for the appellants that the *prima facie* meaning of the words "security" or "securities" is the narrower of the two alternatives already posed and that the meaning will not be extended to the wider alternative in the absence of some context requiring such extension: see, for example, the opinion of Viscount Cave in *Singer v. Williams*, followed recently by Crossman, J., in *Re Smithers* ... applying what I conceive to be proper principles of interpretation to the present case, I do not think that I can, as a judge of first instance, do other than attribute to the word "security" as used in s.44(1)*(e)* of the Act of 1896 the narrower or stricter interpretation.'

29. Having regard to the above discussion, and whilst appreciating the difficulty of finding one genus in paragraph (a), it is our view that the term 'or other security' in the context in which it is used only encompasses instruments that evidence an obligation on the part of the issuer or drawer to pay an amount to the holder or acceptor, whether during the term of the instrument or at its maturity. We have drawn this conclusion because each of the listed instruments in paragraph (a) evidences such an obligation. These types of securities will generally be recognised as debt instruments.

The scope of paragraph (d) of the definition of a security

30. While paragraph (a) of the definition specifies items that are more easily recognisable as securities, paragraph (d) includes contracts under which there is a liability to pay an amount. The apparent breadth of that definition is moderated for the purposes of Division 16E by other threshold provisions, and most contracts that ostensibly fall within the definition are taken outside its operation by these mechanisms. The traditional securities' provisions do not contain similarly explicit provisions to filter out many contracts which fall within the broad scope of the definition. On the face of the definition, all contracts which evidence a liability to pay any amount

may be securities, subject to the limited exclusions in subsection 26BB(1). However, having regard to the discussion at paragraphs 22, 28 and 29 of this Ruling, and paragraphs (a), (b) and (c) of the definition of 'security' in subsection 159GP(1) only those contracts that have debt like obligations will usually fall under paragraph (d) of the definition of 'security'.

31. In *Case 23* 95 ATC 249; *Case 10,116* (1995) 30 ATR 1269, Purvis J found that an implied contract of indemnity came within the definition of a security. His Honour held that the right to indemnity was a security within paragraph (d) of subsection 159GP(1). That decision indicates that paragraph (d) brings within the definition of a security contracts which give rise to an obligation to pay an amount, but which would not ordinarily be regarded as debt instruments. We will follow the decision of Purvis J for similar factual circumstances involving an implied contract of indemnity.

Alternative view

32. On the other hand, and with respect, there is a view that it is implicit in the traditional securities' provisions that a relevant security can only be one where, at the time of acquisition, the acquirer holds a reasonable expectation that the security is at least potentially capable of being realised for a gain at some future point.

33. Accordingly, if the opportunity arises in an appropriate matter which is proceeding before the Courts primarily on some other aspect of the traditional securities provisions, we may seek further judicial clarification of the scope of paragraph (d) of the definition.

Is a unit in a public unit trust a 'traditional security'?

34. We have been asked whether units held by investors in various public unit trusts fall within the definition of 'traditional security' in subsection 26BB(1) of the Act. The units may be held in cash management trusts or in property trusts.

35. A unit in a unit trust cannot be a traditional security unless it first satisfies the definition of 'security' in subsection 159GP(1): see paragraph 17 above. Clearly, a unit is not within either paragraph (b) or (c) of the definition of security.

36. A unit in a public unit trust is not a listed item in paragraph (a) of the definition. Accordingly, it would have to come within the general term 'or other security' to fall within that paragraph. The rights and interests of a unit holder will generally be determined by the provisions of the relevant unit trust deed under which the unit is issued. We expect that in most cases a unit holder will have an

undivided interest in the property of the trust fund which may be expressed as a ratio of units held to total units issued. The units are thus a measure of a unit holder's interest in property. In the light of that characterisation and the discussion in paragraphs 24 to 29 above, we do not believe that a unit in a public unit trust is, of itself, a security of the sort specified by paragraph (a).

37. Depending on the circumstances, the relationship between the unit holder and the manager of the trust may be contractual in nature. If so, there may exist a 'contract ... under which a person is liable to pay an amount or amounts'.

38. H A J Ford, 'Public Unit Trusts', in *The Law of Public Company Finance*, eds R P Austin and R Vann, 1986, Law Book Company, stated (at 401):

> 'So far as legal relations between the manager and the unit holders are concerned they would appear to arise from the acceptance of the application for units made by an investor to the manager ... By the common form of application the applicant agrees to be bound by the provisions of the trust deed and the terms of the offer of units. The manager's acceptance of the application and the allotment of units is likely to be regarded as a contract on the terms of the trust deed so far as it imposes obligations on the manager vis-a-vis unit holders and vice versa.'

39. It would appear from the above that where the manager of a public unit trust is required to buy-back and/or redeem units on terms set out in the trust deed, whether at the request of the unit holder or upon the determination of the trust, the obligation is contractual in nature. As that arrangement seems to be a contract under which there is a liability to pay an amount, it may satisfy the provisions of paragraph (d) of the definition, if, on the facts, it is found to be debt like.

Does a guarantee create a 'traditional security' in the hands of the guarantor?

40. This question arises when a taxpayer guarantees the debt of another person. The contract between the guarantor and the creditor creates a corresponding obligation on the principal debtor to indemnify the guarantor. The obligation of the debtor has been said to be a traditional security in the hands of the guarantor under paragraph (d) of subsection 159GP(1): see *Case 23* 95 ATC 249; *Case 10,116* (1995) 30 ATR 1269.

41. A guarantee is an accessory contract by which the promisor undertakes to be answerable to the promisee for the debt, default or

miscarriage of another person whose primary liability to the promisee must exist or be contemplated. In most jurisdictions it is required by statute that the contract must either be in writing or evidenced by a written note or memorandum signed by or on behalf of the party to be charged. The guarantor or surety is the person who engages with the creditor of a third party to be answerable in the second degree for the liability of the third party: see generally *Halsbury's Laws of England*, 4th edition, Volume 20, paragraphs 101-106.

42. *Chitty on Contracts*, 26th edition, 1989, Sweet and Maxwell, states (at paragraph 5065):

> 'A surety who has actually met the liability which he has undertaken to answer for is entitled to be indemnified by the principal debtor ... Where the surety has undertaken his liability at the request, expressed or implied, of the debtor this right may be said to arise in one of two ways; that is, either from an implied actual contract between surety and debtor, or it may be said to be a restitutionary remedy arising from the fact that the surety has been compelled by law to discharge a debt for which the debtor is ultimately liable.'

43. The implied actual contract is entered into at the time the guarantor gives the guarantee to the creditor: *Re A Debtor (No 627 of 1936)* [1937] 1 All ER 1. The Court of Appeal also confirmed a long line of authority supporting the proposition that the debt due to the guarantor by the debtor under the implied contract does not arise until the guarantor has been called upon to pay the creditor under the guarantee. Greene LJ said (at 8):

> 'The implied undertaking to indemnify is an undertaking to re-imburse the guarantor upon the happening of a contingency, viz., payment by the guarantor to the creditor, and until that contingency happens, there is no debt.'

44. The 'implied actual contract' cannot be a traditional security unless it is first identified as a 'security' as defined in subsection 159GP(1) of the Act. It can be so only under paragraphs (a) or (d) of that definition.

45. For the reasons given in paragraphs 24 to 29 above, and adopted at paragraph 36 in relation to units in a trust, we do not accept that a guarantor who has the benefit of a debtor's 'implied actual contract' has a contractual right that satisfies the term 'or other security' in paragraph (a) of the definition of security. Similarly, we do not accept that the restitutionary remedy is a security under paragraph (a).

46. However, as noted at paragraphs 31 and 40, Purvis J found, in *Case 23* 95 ATC 249; *Case 10,116* (1995) 30 ATR 1269, that an implied contract of indemnity was a security within paragraph (d) of subsection 159GP(1). In the light of the discussion at paragraph 43, it

seems that a present liability to pay any amount pursuant to an implied contract of indemnity does not arise until the guarantor meets its obligations under the guarantee. Accordingly, we consider that the right of indemnity will be acquired as a security within paragraph (d) at that time.

47. The restitutionary remedy that arises when the debt is paid by the guarantor is not founded in contract and, therefore, the terms of paragraph (d) cannot be satisfied.

Disposal: debt forgiveness

48. Subsection 70B(2) provides that where 'a taxpayer disposes of a traditional security ... the amount of any loss on the disposal ... is allowable as a deduction from the assessable income of the taxpayer of the year of income in which the disposal ... takes place'.

49. We have been asked whether, prior to 1 July 1992, a traditional security can be disposed of by forgiving or waiving the debt of the issuer of the security.

50. The word 'dispose' is defined in subsection 26BB(1) as follows:

> ' "**dispose**", in relation to a security, means sell, transfer, assign or dispose of in any way the security or the right to receive payment of the amount or amounts payable under the security.'

51. Forgiving the obligation of a debtor is not the same as selling, transferring or assigning a debt. And when a debt is forgiven, the liability of the debtor to the creditor is extinguished. When a debt is sold, transferred or assigned, the debtor's liability does not cease to exist. Accordingly, for the act of forgiveness to satisfy the definition of 'dispose' in subsection 26BB(1) it would have to fall within the phrase 'dispose of in any way' within that definition.

52. There should be no difficulty in establishing whether a security or the right to receive payment has been sold, transferred or assigned. But the meaning of the clause 'dispose of in any way', in the context in which it appears in the above definition, is open to interpretation.

53. In *F C of T v. Wade* (1951) 84 CLR 105, Dixon and Fullagar JJ, when considering the term 'disposed of' in the former section 36 of the Act, said (at 110):

> 'The words "disposed of" are not words possessing a technical legal meaning, although they are frequently used in legal instruments. Speaking generally, they cover all forms of alienation.'

54. In *Henty House Pty Ltd (In Voluntary Liquidation) v. F C of T* (1953) 88 CLR 141, Williams ACJ, Webb, Kitto and Taylor JJ said (at 152):

> '... the words "is disposed of" are wide enough to cover all forms of alienation, ... and they should be understood as meaning no less than "becomes alienated from the taxpayer", whether it is by him or by another that the act of alienation is done.'

55. The above cases did not deal with the traditional securities' provisions and the comments noted clearly relate to a general understanding of the clauses 'disposed of' and 'is disposed of'. They indicate that all forms of alienation will usually effect a disposal, as that term is generally understood. However, the comments do not go as far as suggesting that a general, unqualified understanding of those clauses means that all acts of disposal must necessarily effect an alienation.

56. Accordingly, in our opinion, a general understanding of acts of disposal would ordinarily include certain actions which do not effect an alienation of the security or right to payment. If not for the specific definition (at section 26BB(1)), the word 'dispose' in the traditional securities' provisions might take the general meaning and encompass actions which do not bring about an alienation of property. Similarly, if the clause 'dispose of in any way' stood unqualified and by itself, it could embrace actions which do not effect an alienation of a security or a right to payment. But there is a specific definition of 'dispose', and 'dispose of in any way' does not stand by itself in that definition. That clause is preceded in the definition by the words 'sell, transfer, assign' and those words all describe means by which property is alienated. More fundamentally, the subject property continues to exist after being disposed of by any of those specific means.

57. Application of the *ejusdem generis* principle requires that the interpretation of the clause 'dispose of in any way' should evidence any genus apparent in the specific terms which precede it in the definition of 'dispose'. The genus in the words 'sell, transfer, assign' suggests that the form of disposal should effect an alienation of the security or right to payment from the holder, and, at the very least, that the security or right to payment should continue to exist after the action.

58. This meaning of the words 'dispose of' in the definition of 'dispose' for the purposes of the traditional securities' provisions was approved by Purvis J in *Case 23* 95 ATC 249 at 256; *Case 10,116* (1995) 30 ATR 1269 at 1277, where he held that:

> 'It is clear then that the meaning to be ascribed to the words "dispose of" is one consistent with alienation. The words "sell", "transfer" and "assign" all convey this sense of alienation. An

> extinguishment of a debt, ... will not then satisfy the definition of "disposal" for the purposes of s 70B.'

Alternative view

59. Accordingly, for the purposes of these provisions, we do not accept the alternative, wider view that forgiving or extinguishing a debt that was a traditional security was sufficient prior to 1 July 1992 to dispose of a security or a right to receive payment of the amount or amounts payable under a security.

60. While we acknowledge that this alternative view is not without some merit, if any significance is to be attached to the position of the clause 'dispose of in any way' in the definition, following words conveying a clear and particular sense, we respectfully consider that the view adopted by Purvis J must be preferred.

61. However, in the event that we are wrong, and forgiveness was sufficient to effect a disposal of a security, one needs to consider whether or not the debt has in fact been forgiven. It is well-established that purported acts of forgiveness or waiver of indebtedness will not be effective unless the creditor has received adequate consideration for the release, the release has been under seal or circumstances exist whereby the former debtor is entitled to allege an estoppel. Merely writing off a debt (with or without an accompanying resolution, in the case of a corporation) will in any event be insufficient: see, for example, *Hall v. Commissioners of Inland Revenue* (1926) 11 TC 24, and, more recently, *Case W115* 89 ATC 899 at 913; *Case 5406* (1989) 20 ATR 4063 at 4078.

62. Subsection 70B(5) makes it beyond doubt that, on and after 1 July 1992, the release or waiver of a debt cannot constitute the disposal of a traditional security for the purposes of section 70B: see subsection 70B(5).

Can there be a disposal where the issuer company is in liquidation?

63. Where a taxpayer disposes of a traditional security or a traditional security of a taxpayer is redeemed, subsection 70B(2) allows a deduction for any loss on the disposal or redemption of the security. When a traditional security matures and the issuer honours the obligation to pay the promised amount, the security may be said to have been redeemed by the issuer.

64. In some cases the issuer may not be able to redeem its securities at the time they mature. This may occur where, for example, the issuer is a company and is insolvent at the time the securities mature.

We also consider that, in such circumstances, for the reasons mentioned in paragraphs 48 to 60 above, the holder has not disposed of the security, in the sense required by subsection 70B(2).

65. Further, in considering whether a security has been disposed of, it seems clear that the terms of subsection 70B(2) require any act of disposal to be an act of the taxpayer who held the security. While a particular security might ultimately cease to exist or become worthless because of the liquidation or dissolution of the issuer company, neither of those consequences means that there has been any act of disposal (as defined) which has been taken by the taxpayer.

66. The outcome may be different where an issuer redeems securities from the holder, whether pursuant to a court-approved scheme or otherwise, for less than the purchase or issue price. When a security is redeemed in those circumstances, but subject on and after 1 July 1992 to the application of subsection 70B(4), there will generally be a loss on the redemption for the purposes of the traditional securities' provisions.

Disposal: death of the holder

67. On the death of a taxpayer, the property of the deceased taxpayer passes to his or her estate, legal control over which is exercised by an executor or administrator. The executor or administrator, in effect, steps into the shoes of the deceased and winds up the deceased's personal affairs. An executor of a deceased person who leaves a will must obtain probate of the will. This is the official proving of the will and provides the executor with authority to deal with the estate. When probate has been granted, the executor is free to call up the deceased's assets and liabilities, and pay the debts, funeral and testamentary expenses. After these matters have been attended to, the executor distributes the property of the deceased to the beneficiaries of the estate.

68. A traditional security held by a taxpayer at the time of the taxpayer's death will not be taken to have been disposed of by the deceased at that time. If the executor subsequently disposes of the security otherwise than by transferring the security to a beneficiary of the deceased estate, or the security is redeemed, a disposal or redemption of the security will have occurred for the purposes of section 26BB and section 70B. Any gain or loss on the disposal or redemption of the security will be the difference between the consideration given by the deceased taxpayer for the acquisition of the security and the consideration received by the executor in respect of the disposal or redemption.

69. A beneficiary will be taken to have acquired a traditional security received by way of a distribution from a deceased estate. We

take the view that, except where we apply the provisions of subsections 70B(3) or 26BB(3), the consideration for the acquisition is the same as the consideration originally given for the acquisition of the security by the deceased. Any subsequent gain or loss arising upon the disposal or redemption of the security will be assessable or deductible to the beneficiary in the normal way.

Subsection 159GP(2)

70. If subsection 159GP(2) were to be applied because of a non-arm's length transaction in relation to the issue of a security, then what might otherwise be a traditional security may become a qualifying security for the purposes of Division 16E. However, except in the most unusual cases, it can be expected that the Commissioner will exercise the discretion given in paragraph 159GP(2)(b) and decide that subsection 159GP(2) should not apply in relation to the issue of what would otherwise be a traditional security.

How does section 70B(3) operate?

71. Subsection 70B(3) provides, broadly, that where the Commissioner is satisfied that the parties to a transaction whereby a traditional security is acquired or disposed of are not dealing with each other at arm's length in relation to the transaction, the consideration for the transaction shall be taken to be an arm's length amount, unless an arm's length amount cannot be practically determined. In that event, the consideration will be the amount that the Commissioner determines.

72. A taxpayer might, for example, pay more for a security than would reasonably be expected. If that excessive purchase price was paid because the taxpayer and the issuer were not dealing as independent parties at arm's length, and the security was subsequently disposed of for a loss, subsection 70B(3) will enable the Commissioner to reduce that purchase price for the purposes of the traditional securities' provisions. The reduced purchase price will be the amount that might reasonably be expected if the acquisition price had been negotiated on an arm's length basis. If, for any reason, an arm's length price cannot be determined, the Commissioner can determine the purchase price.

73. Similarly, subsection 70B(3) authorises the Commissioner to increase the consideration for which a security is disposed of if the consideration received on disposal is less than might reasonably be expected in a disposal at arm's length, and the taxpayer seeks a deduction pursuant to subsection 70B(2) for any loss.

74. The term 'dealing with each other at arm's length' was considered by Davies J in *Re Hains (dec'd); Barnsdall v. FC of T* 88 ATC 4565; (1988) 19 ATR 1352. The case concerned an assessment that, *inter alia*, included in the assessable income under the former section 26AAA of the Act a deemed profit arising on the disposition of shares by the taxpayer to a private company controlled by the taxpayer. Former subsection 26AAA(4) provided that if property was sold for a greater or lesser amount than its value, the consideration was deemed to be its actual value. The subsection only operated if the Commissioner was satisfied that the taxpayer and the person to whom the property was sold 'were not dealing with each other at arm's length'. At ATC 4568; ATR 1355 Davies J said:

> '...s 26AAA(4) used the expression "not dealing with each other at arm's length". That term should not be read as if the words "dealing with" were not present. The Commissioner is required to be satisfied not merely of a connection between a taxpayer and the person to whom the taxpayer transferred, but also of the fact that they were not dealing with each other at arm's length. A finding as to a connection between the parties is simply a step in the course of reasoning and will not be determinative unless it leads to the ultimate conclusion.'

75. In *Trustee for the Estate of the late A W Furse No 5 Will Trust v. FC of T* 91 ATC 4007; (1990) 21 ATR 1123, Hill J, when considering whether parties were dealing with each other at arm's length, said (at ATC 4015; ATR 1132):

> 'What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining.'

76. Once the conclusion is reached that the parties to a transaction were not dealing with each other in relation to the transaction as arm's length parties would normally do, subsection 70B(3) provides (as indicated previously) that for the purposes of determining the amount deductible under subsection 70B(2) the consideration for the transaction shall be taken to be:

> '(a) the amount that might reasonably be expected for the transaction if the parties were independent parties dealing at arm's length with each other; or
>
> (b) where, for any reason it is not possible or practicable for the Commissioner to ascertain that amount - such amount as the Commissioner determines.'

77. So, for example, if a taxpayer lends money to another person and that loan is a traditional security, the taxpayer has acquired a

security for the purposes of sections 26BB and 70B. If the parties are not dealing at arm's length in relation to either the acquisition or disposal of the loan, and consequently a loss is incurred on disposal of that security for which a deduction under section 70B is sought, subsection 70B(3) will apply. The Commissioner will need to consider whether the taxpayer has paid more to acquire or received less to dispose of the security than would reasonably be expected if the purchase and/or the disposal amounts had resulted from a process of 'real bargaining' between independent parties.

78. In considering the initial purchase consideration provided to acquire the security, we will obviously have to determine precisely what it was that the taxpayer acquired. In the case of a loan, the taxpayer/lender acquires the borrower's promise. If, for example, in a non-arm's length dealing, the borrower promises to pay an amount of money on demand, but free of any interest, the Commissioner must first attempt to determine what an independent party would have paid at that time - as a consequence of real bargaining - for that promise.

79. It might be said that the value of the promise is the face value of the amount to be repaid. Immediately after advancing the funds, the lender could reclaim the full amount by an immediate demand. The decision in *Fadden v. FC of T* (1945) 70 CLR 555 is said to support this conclusion.

80. However, *Fadden's* case was concerned in particular with the application of sections 4 and 17 of the *Gift Duty Assessment Act 1941*. The essential issue there was whether a constructive gift could be found in the making of an interest free loan which was repayable on demand, because the consideration for the loan was not thought to be fully adequate. The promise to pay was found to be immediately enforceable and, as the consideration was found to be adequate and there was no constructive gift, no amount of gift duty was payable.

81. In applying subsection 70B(3) we are not concerned with finding the existence of a constructive gift, and the terms of the subsection do not confine the enquiry to the adequacy of consideration as that concept applied in the context of the *Gift Duty Assessment Act*.

82. Subsection 70B(3) requires consideration of whether or not parties were dealing at arm's length. If the parties were not so dealing, the subsection authorises the determination and substitution of amounts that would reasonably have been expected to be the result of real bargaining between independent parties or, if such amounts cannot be determined, of amounts that the Commissioner determines.

83. Real bargaining between independent parties would not ordinarily result in an advance of money, free of interest and repayable on demand. *Prima facie*, such a security is not the outcome of real bargaining. In a process of real bargaining, independent parties

lend to make a gain from that loan. The prospect of mere repayment of the face value of funds advanced (albeit on demand) would in our opinion be insufficient to induce an independent party to advance any money. We believe that an independent party would require undertakings from the borrower about the term of any loan and the repayment of principal and the gain that the lender will receive as compensation for being deprived of the use of its money.

84. Where in any case we conclude that an independent party acting at arm's length would not advance any funds on the actual terms of the subject security (for example, where the security is expressed to be free of interest and repayable on demand), it would not be possible to determine what would reasonably be expected as an arm's length consideration. Accordingly, in such a situation, we will have recourse to the provisions of paragraph 70B(3)(b) to determine for the purposes of section 70B the amount for which the security was acquired.

85. Where it is possible to determine an arm's length consideration, the Commissioner may use a discounted cash flow analysis where there is no established market from which an arm's length value can be determined.

86. The price or value of a security is normally determined by the time value of money, the risk associated with the transaction and the length of time the lender will be without the use of the money. Where a loan carries a rate of interest which reflects the risk associated with the arrangement (i.e., a true commercial rate) and the principal is repayable at the end of the term, the arm's length consideration for the transaction is the face value of the loan. However, where a loan carries an interest rate which is less than a true commercial rate (i.e., where the loan doesn't carry a rate which adequately reflects the above factors), the arm's length consideration in respect of the acquisition of the security will be some amount less than the face value of the loan.

87. Calculating an arm's length consideration for the acquisition or disposal transaction requires ascertaining both the period of the loan and an appropriate rate to discount the cash flows under the security. Where the parties to a loan claim that there was an understanding about the likely period of the loan, we will accept that term if it can reasonably be supported from the facts surrounding the particular case. An appropriate discount rate is determined taking into account the time value of money and adding a premium for the risk associated with the transaction. However, given the administrative and technical difficulty of undertaking a precise risk analysis of each transaction that will come under consideration, appropriate benchmark interest rates may be used. Depending on the circumstances, this could be the general rate charged by a financial institution on an unsecured personal loan, a business loan, the prime corporate lending rate or some other appropriate benchmark rate.

88. In some circumstances it might not be possible to use a benchmark rate. For example, at the time a loan was advanced between related parties it might have been apparent that the loan was attended by extraordinary and unquantifiable risk, or there might have been no indication or understanding between the parties about the term of the loan, and thus it would not be practicable or possible to determine the consideration that would reasonably be expected by a lender acting at arm's length. In those sorts of circumstances, we will apply the provisions of paragraph 70B(3)(b) and, having regard to all relevant factors, determine an appropriate consideration for which the security was acquired or disposed of. It may sometimes be that (for example) the risk attached to a particular loan was so high and any realistic expectation of repayment was so obviously slight at the time of making a particular loan that no party acting at arm's length would have been prepared to advance any funds to the borrower. The consideration for which that sort of security was acquired might be adjusted for the purposes of section 70B to a negligible amount. It follows that any loss deductible pursuant to subsection 70B(2) will be similarly negligible.

89. Examples illustrating the discounted cash flow approach in the application of subsection 70B(3) commence at paragraph 122 below.

90. Some concern has been expressed that a gain might be imputed where none has actually been received by employing this discounted cash flow technique in the application of subsections 70B(3) and 26BB(3). For example, it has been suggested that an interest free loan between parties not acting at arm's length could give rise to a gain to the lender if the loan was subsequently repaid in full. That is, a gain could arise if, for the purposes of section 26BB, the consideration at which the security was acquired was reduced by the application of a commercial arm's length discount to an amount less than that actually lent. The suggestion was that there would be an imputed section 26BB gain which represented the difference between the amount repaid by the borrower and the discounted face value of the original loan.

91. We view subsections 26BB(3) and 70B(3) as discretionary provisions, similar to the provisions at subsection 159GP(2) relating to qualifying securities. If, as in the example above, no actual gain in money terms has arisen, and the only relevant considerations were that there was merely an advance of money and the repayment by the borrower of an equal amount, then (despite the parties not acting at arm's length) we will not have recourse to subsection 26BB(3) to calculate a gain on the disposal of the security by a discounted cash flow technique or any other means.

92. Funds are commonly transferred between companies within corporate groups under informal arrangements. In these

arrangements, as in all other circumstances, the existence of a security must be established before either section 26BB or section 70B can have any practical application. If, for example, money is transferred without contemporaneous documentation from one entity to another within a corporate group, or an entity merely pays the debt of an associate, it would be difficult (without more) to find a 'security' as defined by subsection 159GP(1). Some such dealings might be fraudulent dispositions of funds which do not give rise to the acquisition of any security. Even where informal arrangements do create a security, the dealings between the associated entities in relation to the acquisition, disposal or redemption of that security will need to be carefully considered in the light of subsection 70B(3).

Part IVA

93. Notwithstanding the potential application of subsection 70B(3) in cases where there has been a non-arm's length disposal of a traditional security, Part IVA of the Act may apply to deny a deduction under section 70B.

94. Broadly speaking, Part IVA applies where a taxpayer obtains a tax benefit in connection with a scheme to which the Part applies. The Part applies if, from an objective view of a scheme and its surrounding circumstances, it would be concluded that it was entered into for the sole or dominant purpose of obtaining the tax benefit.

95. Part IVA may have application in cases where there has been a non-arm's length disposal - for example, in the case of an assignment of a security to a related party. Although we would expect that in most circumstances the provisions of subsection 70B(3) would be sufficient to deal with any such arrangements, we are not prepared to rule out the potential application of Part IVA. Careful scrutiny of section 70B deductions can be anticipated in respect of claims arising out of these sorts of arrangements, particularly within company groups, to determine whether Part IVA of the Act applies.

96. [Withdrawn]

The amount of gain on disposal: incidental costs

97. Subsection 26BB(2) provides that the amount of any gain on the disposal or redemption of a traditional security shall be included in the assessable income. We have been asked whether incidental costs associated with the acquisition and disposal of the security can be taken into account when calculating the gain derived.

98. Having regard to the language used, we think that those costs may be taken into account in determining the amount of any gain or loss on disposal.

Consideration on disposal or redemption: payment in the form of shares

99. If a taxpayer disposes of a traditional security or a traditional security is redeemed and the consideration received consists of shares in the issued capital of a company, it is necessary to determine the value of that consideration.

100. Section 21 of the Act provides:

> 'Where, upon any transaction, any consideration is paid or given otherwise than in cash, the money value of that consideration shall, for the purposes of this Act, be deemed to have been paid or given.'

101. We think that the money value of shares in these circumstances is the same as the market value of the shares: *Case 88* 13 CTBR (NS) 571. The par value or paid up value of the shares is not necessarily their money value and calculations using these amounts may not satisfy the terms of section 21.

101A. The *New Business Tax System (Taxation of Financial Arrangements) Act (No. 1) 2003*, amended sections 26BB and 70B of the *Income Tax Assessment Act 1936* by inserting subsections 26BB(4) and 26BB(5) and subsections 70B(2B) and 70B(2C). The effect of these amendments is that subsections 26BB(2) and 70B(2) do not apply to the disposal or redemption of a traditional security if the security:

i) was issued after 7:30pm by legal time in the Australian Capital Territory on 14 May 2002; and

ii) was issued on the basis that the security will or may be:

   a. disposed of or redeemed because of conversion into ordinary shares of the issuer or a connected entity of the issuer;

   b. redeemed for ordinary shares in a company other than the issuer or a connected entity of the issuer; or

   c. disposed of to the issuer or a connected entity of the issuer in exchange for ordinary shares in a company other than the issuer or a connected entity of the issuer; and

iii) the disposal or redemption took place pursuant to a provision of the issue of the security that is listed at (ii).

For securities that meet all of the above conditions, it will not be necessary to determine the money value of the shares.

Issuer of a security: redemption at less than the issue price

102. It has been suggested that subsection 26BB(2) applies to any gain made by the issuer of a traditional security upon the redemption of the security for less than its issue price. We do not agree with that proposition. The first part of the definition of 'traditional security' provides:

> ' "**traditional security**", in relation to **a taxpayer**, means a security **held by the taxpayer** that:
>
> (a) is or was **acquired by the taxpayer** after 10 May 1989' (emphasis added).

Accordingly, we do not think that the taxpayer holding or acquiring a traditional security in the required sense can be the taxpayer who issued the security.

103. Moreover, the 'taxpayer' first mentioned in subsection 26BB(2) is the holder of the traditional security immediately before the 'disposal'. The second-mentioned 'taxpayer' in the subsection, in relation to the redemption of a security, is also the holder of the security immediately prior to the redemption.

104. Accordingly, there is no warrant for reading the subsection as applying to the issuer of a traditional security. Subsection 26BB(2) does not, therefore, include in the assessable income any 'gain' realised by the issuer of a traditional security upon redemption of that security because the security is redeemed for less than its issue price. Similarly, any 'loss' made by the issuer of a traditional security when redeeming the security is not deductible under section 70B.

105. The above conclusions in relation to sections 26BB and 70B do not mean that in appropriate circumstances gains and losses of a revenue nature experienced by the issuer of a traditional security will not be assessable under subsection 25(1) or deductible under subsection 51(1) as the case may be. For example, in *Mutual Acceptance Ltd v. FC of T* 84 ATC 4831; (1984) 15 ATR 1238 the gain made by a finance company representing the difference between the issue price of debentures and the amount at which they were redeemed was held to be assessable income. See also the discussion by McHugh J in *Coles Myer Finance v. FC of T* 93 ATC 4214 at 4231; (1993) 25 ATR 95 at 117.

When is a 'deposit' acquired?

106. The definition of 'security' in subsection 159GP(1) provides that a security includes:

> '(b) a deposit with a bank, building society or other financial institution.'

107. A deposit will not be a traditional security if it has been acquired on or before 10 May 1989. The term 'acquire' is defined in subsection 26BB(1):

> ' "**acquire**", in relation to a security, means acquire, on issue, purchase, transfer, assignment or otherwise, the security or the right to receive payment of the amount or amounts payable under the security.'

108. G A Weaver and C R Craigie, *The Law Relating To Banker and Customer in Australia*, 1990, Law Book Company, describe interest bearing deposits (at para 3.600) in the following terms:

> 'In Australia banks accept interest bearing deposits for fixed terms and at call ... Deposits for fixed terms are called term deposits, fixed deposits, or interest bearing deposits ... under the Australian system the conditions on which the deposit is accepted are either embodied in a receipt, or can be determined by reading together both the customer's written request to the bank to accept the deposit and the receipt. Thus there is a separate receipt and a separate contract for each deposit.'

109. In view of the above, we think that each fixed deposit, being a separate contract, is a paragraph (b) security for the purposes of the definition in subsection 159GP(1). Accordingly, a customer who makes a fixed deposit with a financial institution has 'acquired' a security at the time of making the contract.

Is a current account a security?

110. Weaver and Craigie (supra) describe a current account (at para 7.40) as follows:

> 'Current is used here in the sense of flowing or running, like a stream...the moneys paid to the bank for credit of the customer's account form one incoming stream, while an outgoing stream of payments is made by the bank at the customer's direction ... After payment to the bank all these moneys become one single fund at the disposal of the customer.'

111. It can be seen from the above that a deposit with a bank (i.e., a fixed deposit) is different from an account with a bank (i.e., a current account or a savings account), whether interest bearing or not. The

records of term deposits in a bank's books are not strictly accounts in the conventional sense because the customer does not operate on them. This is unlike a savings account which is able to be operated by the customer in the same way as a current account.

112. Notwithstanding the above, we accept that an account with a bank can be a traditional security, given that a debtor/creditor relationship exists between the bank and the customer. In this sense it does not matter whether the debt is in respect of the amount on deposit or the amount standing to the credit of the account. The nature of the relationship is not altered by an agreement by the banker to allow interest on the balance in the account: *Foley v. Hill and Ors* [1843-60] All ER Rep 16.

When is the current account acquired?

113. Like a fixed deposit, we think that a traditional security, being the debt owing from the bank on a current or savings account with an institution, is acquired when the account is opened - i.e., when the contract between the banker and customer is entered into.

114. The amount of the debt owed to the customer in respect of a current or savings account at any particular time is the balance of the account. The balance of the account is one and indivisible and the customer's right to withdraw the credit balance is a single, not a composite, chose in action: *Alcom v. Republic of Colombia* [1984] AC 580.

115. Weaver and Craigie (ibid) describe the English 'deposit account' as follows:

> 'In England some deposits are accepted for fixed terms but a more usual arrangement in that country is for a deposit account on which interest is calculated on a day to day basis, and to which the customer can deposit further moneys from time to time. Withdrawals can be made either of the whole or part of the balance on giving a fixed period of notice; 14 days notice is quite usual. The English Court of Appeal has held (*Hart v. Sangster* [1957] Ch 329; [1957] Ch 329) that for such an account there is one continuing contract. No doubt the same would apply if a comparable system were to be adopted in Australia.'

116. In *Hart v. Sangster (Inspector of Taxes)* [1957] 2 All ER 208, Lord Goddard CJ was seemingly of the view (at 210) that in many respects there was no difference between a deposit account and a current account. From the point of view of whether both kinds of accounts were one continuing contract there is no apparent difference. In *N Joachimson (A Firm Name) v. Swiss Bank Corporation* [1921]

All ER Rep 92, Atkin LJ when discussing the characteristics of a current account said (at 100):

> 'I think there is only one contract made between the bank and its customer.'

117. Whilst a bank borrows money from a customer under terms to repay it, the credit balance in a current account does not become due and payable until the customer demands payment of it: *N Joachimson v. Swiss Bank Corporation* (supra). The position is that there is an implied obligation on the part of the customer to make an actual demand for the amount standing to his credit on current account as a condition precedent to a right to sue for that amount.

118. In this respect, Bankes LJ said (at 96):

> 'Unless this were so, the banker, like any ordinary debtor, must seek out his creditor and repay him his loan immediately it becomes due - that is to say, directly after the customer has paid the money into his account - and the customer, like any ordinary creditor, can demand repayment of the loan by his debtor at any time and any place.'

119. Notwithstanding that the right to sue for the account balance only arises once a demand has not been satisfied, the security - i.e., the debt owing from the bank - is acquired under the contract entered into when the account is opened. That is to say, an account holder acquires the security, being the debt that arises under the contract entered into, when the account is opened and not when subsequent deposits are made to the account.

Inter-company loans

120. Companies within the same group frequently advance and draw funds from a designated group company under a 'pool of funds' approach. Even where the designated company might not be held to be a finance company, it performs a function commonly described as group-financier or banker. In our opinion, the nature of the arrangements under which the group companies deposit and withdraw funds from that company are similar to those under a current account. Accordingly, in cases involving an inter-company loan that may involve more than one draw-down, the approach outlined above in relation to current accounts with financial institutions should be taken. As with a bank account, the lender acquires a security when the contract establishing the loan is entered into.

121. There may be other circumstances in which related companies regularly operate an inter-company loan account. We consider that such accounts will also be similar in nature to current accounts. Accordingly, in those circumstances the traditional security will be the

debt owed from time to time by one company to the other and will be acquired when the loan account first comes into existence.

Examples

Example 1

122. A taxpayer lent $16,000 to a private company which the taxpayer controlled. The loan was made on 30 May 1989. The loan was unsecured, repayable in five years, and carried no interest rights. The company was experiencing liquidity problems and trading prospects in the short term were poor. Assume that, at that time, a commercial rate of interest which appropriately reflected the return and risk associated with that type of loan in circumstances similar to those of the borrower was 17% per annum. The borrower's circumstances subsequently deteriorated, and, on 30 June 1991, the taxpayer assigned the loan to a third party for $50, which was an amount which properly reflected the true commercial value of the loan at that time. The taxpayer claims a loss pursuant to section 70B of $15,950.

123. The assignment of the debt on 30 June 1991 constituted the disposal of the debt (a disposal in these circumstances on or after 1 July 1992 would need to be considered in the light of subsection 70B(4)) and the parties to the assignment were dealing with each other at arm's length in relation to that disposal. Subsection 70B(3) will have no application to the consideration received on disposal of the security. However, in respect of the acquisition by the taxpayer of the security, we contend that the parties were not dealing with each other at arm's length.

124. In applying paragraph 70B(3)(a), we believe the relevant enquiry should be directed at determining the consideration that a lender acting at arm's length would have been willing to advance on 30 May 1989 to obtain that borrower's promise to repay $16,000 in 5 years. The arm's length consideration for the acquisition of the security would have been the sum of the present values of all the payments to be made under the security. As the loan did not carry interest the only receipt will be the repayment of the principal. Accordingly, only one present value calculation needs to be performed:

$$\text{Arm's length consideration:} = \frac{\text{Face Value of Loan}}{(1 + r)^n}$$

where r = interest rate

n = number of years

$$= \frac{16{,}000}{(1 + 0.17)^5}$$

$$= \$7{,}298$$

The maximum loss on disposal allowable under subsection 70B(2) is the arm's length consideration for the acquisition ($7,298) less the amount received on disposal ($50) - i.e., $7,248.

Example 2

125. On 1 August 1989 a company lent $100,000 to a subsidiary for 5 years at 10% interest per annum. The commercial rate of interest at that time was 16% per annum. The subsidiary subsequently experienced cash flow difficulties but continued to trade and was expected to be successful in the long term. The parent company assigned all rights in respect of the debt on 1 August 1991 to an associated company for $500 and has claimed a deduction under section 70B of $99,500. At the time of the assignment the appropriate benchmark rate of interest was 20%.

126. As in **Example 1**, we would not accept that the transaction by which the security was acquired was an arm's length dealing. A commercial interest rate was not payable on the loan. Whilst there has been an effective disposal of the debt, the disposal transaction will also not be accepted as an arm's length dealing. Although the subsidiary was experiencing cash flow difficulties, it continued to trade and was expected to be successful in the long term. It is unlikely that an arm's length party would dispose of the right to receive the amounts payable under the loan for negligible consideration. For the purposes of this example, the possible application of Part IVA will be ignored.

127. Calculating an amount for the purposes of paragraph 70B(3)(a) in respect of the consideration for the acquisition of the security should be on the same basis as the calculation in Example 1 above. The consideration in respect of the disposal transaction should be calculated by discounting the future cash flows under the loan using the appropriate benchmark rate of interest at the time the debt was assigned.

Acquisition price (at 1/8/89):

Payment Date	1/8/90	1/8/91	1/8/92	1/8/93	1/8/94
Cash flow	10,000	10,000	10,000	10,000	110,000
divided by					
Discount factor	$(1+.16)^1$	$(1+.16)^2$	$(1+.16)^3$	$(1+.16)^4$	$(1+.16)^5$
Present Values	8,621	7,432	6,407	5,523	52,372
Net Present Value	80,354				

Disposal price (at 1/8/91):

Payment Date	1/8/92	1/8/93	1/8/94
Cash flow	10,000	10,000	110,000
divided by			
Discount factor	$(1+.20)^1$	$(1+.20)^2$	$(1+.20)^3$
Present Values	8,333	6,944	63,657
Net Present Value	78,935		

70B(2) amount:

Arm's length disposal amount	78,935
less	
Arm's length acquisition cost	80,354
equals	
Traditional security loss	(1,419)

Detailed contents list

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